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The political economy of enforcing fiscal rules

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The Political Economy of Enforcing Fiscal Rules

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Abstract

A large literature is focused on governments' fiscal policy making under the disciplining force of fiscal rules. That literature is devoted to map governments' incentives for (non)compliance, but widely ignores the role of fiscal rule enforcement. This is remarkable, given the situation in the European Union, where we observe frequent breaches of the fiscal rules in the absence of sanctions. This paper focuses therefore on the incentives of the European Commission as enforcer of the Stability and Growth Pact (SGP) and on how individual governments take these incentives into account. Based on actual cases and literature on international agreements we distinguish rationales which make the Commission lenient. Accordingly, we present a game theoretical model to map the interaction between the Commission and governments under incomplete information. We find that unforeseen fiscal needs stemming from crises or other contingencies enhance enforcement costs for the Commission. Given that crises require additional public expenditures, our model shows that some enforcement costs are welfare enhancing. We also find that governments have an incentive to emphasize the fiscal impact of crises to increase the Commission's enforcement costs. Moreover, governments might even overstate crises' fiscal impact to hide other expenditures. In doing so, governments exploit their informational advantage over their budget allocation and crisis solving costs. Finally, we provide examples related to Europe's migrant crisis and national security to support our theoretical findings.

Keywords: Fiscal rules, Stability and Growth Pact, enforcement

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1. Introduction

There is a substantial literature focusing on the size and allocation of government budgets which disentangles the incentives of politicians when deciding on fiscal matters. Short sightedness (Alesina and Tabellini, 1990), common pool resource problems (Roubini and Sachs, 1989) and electoral cycles (Alesina and Sachs, 1988) are studied extensively, and are held accountable for the rise of debt levels in developed countries during recent decades. Fiscal rules are raised as one of the measures to discipline governments. Accordingly, numerous papers have been dedicated to the optimal design of fiscal rules and their effect on government spending. For instance, Beetsma and Debrun (2007) show that rigid fiscal rules are disincentives for structural reforms and Dulleck and Wigger (2015) claim that strict fiscal rules might lead budget maximizing governments to overspend.

Although theoretical models have focused on the incentives of governments under fiscal rules, less attention is paid to the incentives of fiscal rules' enforcers. Instead, compliance and enforcement are often taken for granted, or voters rather than political actors are considered as the 'guardians' of fiscal pacts. It is remarkable that theoretical models do not consider enforcement as a deliberate action of a political actor. After all, the way fiscal pacts are designed attributes substantial discretion to enforcers. Due to the complexity of public finances and budget caps, assessment of compliance is heavily subject to human interpretation which gives the enforcer power to affect government spending (Buti, Eijffinger and Franco, 2003). Moreover, cases in the past have shown that enforcers behave strategically and actually use their discretion. For instance, the European Commission (hereafter 'the Commission'), declared in 2004 that it might exempt Iraq war spending from the European deficit ceiling[3], and in November 2015, that it exempted spending on the refugee crisis from the fiscal rules[4]. Finally, one might expect that a political actor takes public opinion and its own popularity into account when considering whether to sanction governments.

This paper considers fiscal rules as a game between governments and a political actor as enforcer. Focusing on the European Union (EU), it aims to map the enforcer's incentives and the manner governments take this into account. In doing so, it draws from concepts in literature developed in other compliance-enforcement contexts, like rulings of the Court of Justice of the EU. In general, it addresses the following questions: What are the incentives of the Commission in enforcing the fiscal rules? And how do individual governments take these incentives into account?

This paper is organized as follows. First, we briefly depict the working of fiscal rules in the EU. We show how governments undermined enforcement and suggest rationales why the Commission avoids

[3] European Commission (2004), "European Economy. Public in EMU 2004", p.83
[4] http://europa.eu/rapid/press-release_IP-15-6067_en.htm

sanctions. We then provide some background on how fiscal rules are captured in the literature and theoretical models. Third, we present a model in which we consider fiscal rules as game between governments and a supranational enforcer. Finally, we provide some examples to support our theoretical findings.

2. The Stability and Growth Pact and enforcement

In the European Union, governments are constrained by deficit and debt rules under the Stability and Growth Pact (SGP) introduced in 1998. In short, deficit levels are not allowed to exceed 3% of a member state's GDP, whereas debt levels are capped at 60%. The Commission is appointed as enforcer of these rules, which implies that it must approve national budgetary plans, monitors the government's fiscal policies, casts official warnings when there is a threat of non-compliance, and can initiate so-called 'Excessive Deficit Procedures' (EDPs) when it observes breaches of the deficit rule. When the Council of the EU approves the establishment of an EDP by qualified majority, the EDP aims to decrease spending in the member state concerned in the subsequent years. It formulates budgetary measures for the government and establishes a deadline for improvement. If governments refuse to cut spending under EDPs, the Commission can ultimately propose to impose a fine, which also requires the approval of the Council of the EU.

Despite its institutional setting, the SGP could not prevent European governments from consolidating and increasing their debt levels over the years. EMU governments consolidated their debt levels in the first years of the SGP and increased their liabilities since the global financial turmoil started in 2007. However, this does not mean that there was no enforcement at all. Between 2004 and 2015, EDPs have been installed in 110/184 of the accumulated country years within the Eurozone. Accordingly, Köhler and König (2014) show that the SGP had some effect on limiting debt levels in Europe, but could not prevent the euro crisis. The rules are violated frequently, EDPs have been installed, but ultimate fines are never imposed. Hansen (2015) found that member states with more votes in the Council, negative GDP growth, high unemployment and Eurosceptic populations tend to violate the SGP rules the most.

We can conclude that compliance and enforcement are not automatic. The literature assigns governments' preference for noncompliance to their deficit bias stemming from short sightedness (Alesina and Tabellini, 1990), common pool resource problems (Roubini and Sachs, 1989), or electoral cycles (Alesina and Sachs, 1988). Theories about weak enforcement and sanctioning decisions of supranational enforcers are rather scarce (König and Mäder, 2014). Since other papers have mapped incentives for (non)compliance, we focus on the enforcement part of the problem. Below, we provide an overview of literature that studied how governments undermine the Commission's enforcement

power. We then elaborate on the Commission's incentives for lenient enforcement, based on actual cases and literature on international agreements.

Government's opportunistic behavior

Member states undermined the Commission's enforcement power in a number of ways. Strauch, Hallerberg, and von Hagen (2004) show that governments provide biased fiscal forecasts in their Stability or Convergence Programmes. While these annual reports are used by the Commission to assess governments' compliance with the SGP, governments report overoptimistic figures to avoid warnings. Brück and Stephan (2006) showed that governments tend to do this more in years prior to elections.

Baerg and Hallerberg (2016) showed that governments successfully weaken the Commission's enforcement power by amending its assessment reports. After the member states submitted their Stability or Convergence Programmes, the Commission evaluates these programmes and issues a report on its findings. Until 2011, however, these Commission reports required a qualified majority in the Council for approval, through which governments were able to amend the Commission's opinion. Baerg and Hallerberg showed that governments were able to make textual changes in the Commission's opinion such that the assessment was weakened. Mainly large member states and states with Eurosceptic populations used these amendments to undermine the Commission's watchdog function.

Another instance in which governments limited the enforcement power of the Commission is represented by the France-Germany case of November 2003[5]. France and Germany did not meet the fiscal targets under their EDPs in 2002 and 2003, after which the Commission proposed to impose fines. However, a qualified majority in the Council had to approve this proposal, but was not obtained. Remarkably, four of the six countries voting against fines had excessive deficits themselves, whereas none of the eight member states in favor had a deficit exceeding 3%[6]. This reveals that the undisciplined governments were able to prevent fines against the other undisciplined governments. Until now, this is the only time that the Commission attempted to impose fines against member states that did not comply with their EDP target. Accordingly, no government is ever fined despite the several breaches.

The Commission's lenience

Besides the attempts of national governments to avoid sanctions, there are also cases in which the Commission refused to enforce the fiscal rules. The Commission has gatekeeping power within the SGP

[5] See Leblond, 2006 for a detailed sequence of events

[6] In favor of sanctions: Belgium (-1.8), Denmark (-0.1), Greece (-1.7), Spain (-0.4), The Netherlands (-3.0), Austria (-1.8), Finland (2.2) and Sweden (-1.3). Opposed sanctions: Italy (-3.4), Ireland (0.8), Luxembourg (0.5), Portugal (-4.4), The UK (-3.4), France (-3.9) and Germany (-4.1). With 2003 budget balances in parentheses.

and some instances show that the Commission has some underlying incentives in its enforcement. Accordingly, the high debt levels in the absence of sanctions raise the question why the Commission is reluctant in imposing sanctions. We broadly distinguish public opinion and the political agenda as rationales that make the Commission careful in its enforcement[7].

First, the Commission takes public opinion into account. Köhler and König (2014) suggest that the Commission faces 'enforcement costs' when it enforces the fiscal rules without the support of voters. This touches upon the Commissioners' personal reputations as politicians, or the reputation of the Commission as supranational institution. People might for instance not like the Commission to sanction member states for public spending related to contingencies outside the control of the government. Therefore, the Commission excludes expenditures related to unusual events from enforcement. Over the years, expenditures related to the foot and mouth disease, the financial crisis and national security after terrorist attacks were exempted. In its report 'Public Finances in the EMU 2015', the Commission provides criteria which have to be fulfilled to qualify for this provision.

Moreover, in times of Euroscepticism, the Commission might be careful in its enforcement to prevent further anti-EU sentiment. In May 2016, for instance, the Commission notified in its Country Specific Recommendations that Spain and Portugal missed their EDP targets in 2014 and 2015. However, rather than stepping up procedures against these countries, the Commission announced to "come back to the situation of these two member states in early July"[8]. European Commissioner for Economic and Financial Affairs Pierre Moscovici added that it "…is not the right moment, economically or politically to take this step [towards fines]" [9]. This statement was immediately interpreted as a strategic move to delay corrective measures till after the Spanish elections on June 26.[10]

Another reason to take public opinion into account is to enhance legitimacy to ensure future compliance. This theory stems from literature on international agreements in which supranational enforcers leverage public opinion to make national governments comply. Governments get punished by voters when they breach international rules without the public's support (Chaudoin, 2014). However, to enhances this public pressure, the people must belief that the rules are binding and legitimate (Carrubba, 2003). Therefore, the Commission wants to avoid enforcement decisions that decrease public support and weaken the public pressure in the future. Hence, when people do not consider the fiscal rules as fair, they will not punish their governments when the rules are breached. This means that the Commission must establish a series of 'good enforcements' in the perspective of the public.

[7] A third rationale is to prevent governments' reluctance to impose structural reforms or to make public investments
[8] http://europa.eu/rapid/press-release_IP-16-1724_en.htm
[9] http://www.ft.com/fastft/2016/05/18/portugal-spain-win-budget-reprieve-from-brussels/
[10] http://www.politico.eu/article/commission-portugal-spain-fine-europe-ducks-hard-call-on-budget-rules/

However, in a setting with multiple countries under one enforcer, gaining legitimacy gives rise to a trade-off (Garrett, Keleman and Schulz, 1998). On the one hand the Commission wants to make sanction decisions which are consistent, signal independency and avoid the appearance of political influences which would mean that the Commission commits to a strict sanction rule, according the letter of the SGP. On the other hand, it wants to avoid decisions without public support which requires a rather customized approach. Therefore, the Commission must take into account that people observe its lenience towards other member states. This incentives the Commission to apply the same set of standards to every country, even when this is suboptimal for individual member states.

Second, the political agenda determines the Commission's enforcement. Despite the fact that the Commission should be independent as enforcer, it has some clear political goals which come to the surface in its decisions. For instance, the Commission exempts EU contributions from the fiscal rules, as well as spending related to the refugee crisis[11] and enhanced national security after terrorism[12]. Due to the international character of the refugee crisis and the threat of terrorism in Europe, the EU was designated as governmental level to solve the issues. The Commission exempted related spending from the fiscal rules to incentivize governments to earmark funds, since these national funds were needed to cope with the issues on supranational level.

Thus, both national governments and the Commission seem to avoid enforcement of the SGP. The incentives of national governments are covered in the literature as well as how governments aim to avoid enforcement. The incentives of the Commission are not studied extensively, so we distinguished three groups of rationales based on cases and literature on international agreements. The examples show that the Commission's discretion within the SGP, combined with its political incentives, can make SGP enforcement a controversial affair.

3. Theoretical models

Although enforcement seems to be a major issue in the context of international rules, it is not well captured in theoretical models (König and Mäder, 2014). Despite the combination of high debt levels and the absence of sanctions, there are little insights about the strategic decisions of the Commission in the SGP. Instead, models are often focused on mechanism design and the compliance incentives of national governments. As a result, models take enforcement for granted or use alternative enforcement mechanisms to capture fiscal rules. A supranational enforcer with gatekeeping powers regarding austerity measures or pecuniary sanctions, is not considered.

[11] http://europa.eu/rapid/press-release_IP-15-6067_en.htm
[12] See e.g. European Commission (2016), "Assessment of the 2016 Stability Programme for Belgium", p.13

Binding fiscal rules

Some models are built upon the assumption that the fiscal rules are binding such that compliance and enforcement are guaranteed. Both Krogstrup and Wyplosz (2010) and Dur, Peletier, and Swank (2004) use binding debt rules to map government's decisions under fiscal pacts. These papers show that fiscal rules are disincentives for governments to take decisions that pay-off in the long run like structural reforms and public investments. In Krogstrup and Wyplosz (2010) a binding debt ceiling is introduced to eliminate the international debt externality stemming from cross-border economic interaction. They find that binding debt rules work to eliminate deficit biases, but also result in lower structural reforms. Dur, Peletier, and Swank (2004) use electoral uncertainty as source of government's overspending. Their binding debt rule effectively mitigates this problem, but has lower public investments as negative side-effect. Beetsma and Debrun (2007) capture fiscal rules by decision rather than game theory. In their model, the government's utility is directly decreased with some 'sanction scheme' if the government increases its debt level. In this setting, enforcement is no decision of an actor, but an automatic correction of the government's utility. In general, these models do not consider enforcement as an actor's decision, whereas the use of binding fiscal rules assumes away the need for enforcement or sanctions.

Enforcement by voters

Another strand of literature introduces voters as enforcers of fiscal rules, in which the voters leverage their electoral control as disciplining mechanism (Besley and Smart, 2007; Debrun and Kumar, 2007; Drazen and Eslava, 2005; Dulleck and Wigger, 2015[13]). In these models, the people set a budget cap, and enforce this cap by a corresponding voting rule. When the government does not suffice the budget cap, it will get voted out of office. For sure, electoral pressures play a role in governments' (fiscal) decision making. However, due to the fundamental differences between the Commission and the people, substituting one by the other has limitations.

First, following Chaudoin (2014), people do not always have the capacity to impose costs on noncompliant governments. Populations can use their votes, but lack direct competences to limit public spending. Due to accountability problems, electoral pressure can hardly enhance fiscal discipline. Person and Tabellini (2004) find that especially in parliamentary systems with proportional representation, voters have difficulties to attribute spending behavior to particular politicians and outvote them. Moreover, the main premise in the literature is that people can outvote an excessive spending politician and elect a challenger, but that there is still uncertainty about the type or spending bias of the newly

[13] Although Dulleck and Wigger (2015) introduce an 'opposition' than can stretch the budget cap, this player has the same utility as the voters. Since it has more information, this player is supposed to inform voters, who subsequently use their votes to sanction the incumbent government.

elected government (Besley and Smart, 2007; Drazen and Eslava, 2005). The Commission, on the contrary, has the means to affect fiscal policies in a more direct fashion. As described in section 2, the Commission must approve annual budgets, can issue warnings, initiate Excessive Deficit Procedures (EDP) and might ultimately impose sanctions.

Second, empirical evidence suggests that electoral pressures provoke spending rather than impose discipline. Known as the political budget cycle, Alesina and Sachs (1986) and more recent Brender and Drazen (2008) show that governments cut taxes and increase spending prior elections to increase their reelection chances. This result suggests that both the governments and the people have a deficit bias which contradicts with the general premise in theoretical models that people's voting rule disciplines governments. In this line, Chaudoin (2014) argues that people only put pressure on their government to comply with international agreements if their policy preferences are aligned with the international agreement. On the contrary, one can expect from the Commission to favor sustainable public finances.

Third, voters do not incur other costs from enforcement than some pecuniary consequences. For instance, in Besley and Smart (2007) and Dulleck and Wigger (2015) voters omit enforcement deliberately to make it not too costly for governments to comply with the budget cap. However, political incentives like the one listed in section 2 are not considered. In contrast, the Commission faces these costs and therefore makes different decisions. Our model takes this into account.

In short, the way how fiscal rules and their enforcement is captured in the theoretical models undermines some political aspects. Many issues that we observe in the enforcement of the SGP are as a consequence ignored. Our model considers enforcement as the decision of a political actor which faces enforcement costs as suggested by Köhler and König (2014).

4. The model

We present an asymmetric information model of public spending in which the government is monitored by a political actor. The government decides on the size and allocation of its budget, while the third actor can sanction excessive spending by taking over budgetary control in the subsequent period. The model uses features of Besley and Smart (2007) and Dulleck and Wigger (2015).

The setup

The model has two periods ($t = 1,2$) in which the government must decide on its budget size and allocation, whereas there are three distinct expenditures where the government can spend its funds on. First, there are general public affairs like public good provision and the government's administration.

We label the expenditures on those regular issues g. Second, crises might occur like natural disasters or other contingencies which require some spending to be managed. We label the expenditures related to crises f. Third, the government can spend its funds on rent-seeking activities which can be considered as waste. This spending is labelled s and might be useless favors to politicians' constituencies. For simplicity we assume that a crisis only occurs in the first period. Accordingly, the government's budget allocation decision is three dimensional in the first period (g, f, s), and two dimensional in the second period (g, s).

We assume that both general public affairs and the crisis require a threshold spending to be managed adequately. Let π be the threshold for general public affairs which is fixed and common knowledge, and θ the threshold for solving the crisis. This latter value is drawn by nature and, to keep things simple, is either low or high: $\theta \in \{L, H\}$ with $\Pr(\theta = H) = q$. People outside the government can in contrast to π not observe θ, although its probability distribution and the values of L and H and are common knowledge[14]. On the contrary, there are no thresholds or implications for 'rent' spending, as rents might only serve government's utility.

Governments can be 'disciplined' or 'undisciplined', which we label by their type $j \in \{d, u\}$. The disciplined government aims to maximize social welfare. The level of social welfare depends on whether general public affairs and the crisis are managed adequately. Like in Dulleck and Wigger (2015), we assume a fixed level of social welfare when the thresholds are obtained. Let $v(g)$ indicate the social welfare stemming from adequately managed public affairs and $v(f)$ from a solved crisis. For the first period, we let:

$$v(g) = \begin{cases} G & \text{if } g \geq \pi \\ 0 & \text{otherwise} \end{cases}$$

$$v(f) = \begin{cases} 0 & \text{if } f \geq \theta \\ -F & \text{otherwise} \end{cases}$$

and for the second period:

$$v(g) = \begin{cases} G & \text{if } g \geq \pi \\ 0 & \text{otherwise} \end{cases}$$

The interpretation of $v(f)$ is that a crisis decreases social welfare with F, unless it is solved. In addition, social welfare decreases in the total amount of public spending. This can be thought of social loss stemming from paying taxes or increased public debt. Let $C(b) = b$ be this loss after total spending $b =$

[14] We consider crises as source of budgetary opaqueness. This could also have been other expenditures which are exempted from fiscal rules like public investments or structural reforms. Moreover, the uncertainty could also represent the economic cycle, where H would represent an economic downturn which requires high government spending, and L good times demanding a lower spending level.

$g + f + s$. Social welfare then becomes $V_1 = v(g) + v(f) - b$, in the first period, and $V_2 = v(g) - b$ in the second period, with total social welfare $V = V_1 + V_2$. We assume that $G > \pi$ and $F > H$ such that social welfare is optimized when public affairs and the crisis are managed adequately, rather than leaving them unmanaged to avoid spending. As a consequence, the disciplined government prefers fiscal policy $(g, f) = (\pi, \theta)$ such that both the general public affairs and the crisis are managed adequately with the minimum amount of spending. This also implies that the disciplined government prefers to set its budget size equal to $\pi + L = b_L$ if there is a small crisis, and $\pi + H = b_H$ when there is a large crisis.

The undisciplined government, on the contrary, only cares about spending on 'rent', so that it maximizes $s_1 + \delta s_2$, where $\delta < 1$ represents the discount factor. The chance that a government is disciplined is equal to $\Pr(j = d) = \sigma$, which is common knowledge. The disciplined government does not discount its second period utility since its interests are aligned with social welfare.

We impose a maximum of B the government can spend per period, where we assume that $B > \pi + H$, such that B is large enough to afford adequate public affairs and crisis spending. One can interpret this as the maximum taxes people are willing to pay, or the government can borrow on financial markets. Thus, the government faces an annual budget constraint equal to $B = g_1 + s_1 + f$ in the first year, and $B = g_2 + s_2$ in the second. Again, we assume that there will be no crisis during the second period (and that this is common knowledge), such that crisis spending f is only relevant in the first period.

In addition to the government, there is a second actor in the model who cares about the public finances. In correspondence to the European setting, we refer to this actor as the 'Commission'. The Commission monitors the public finances and can impose an Excessive Deficit Procedure (EDP) to discipline governments. Such an EDP implies that austerity measures are imposed limiting the government's budget in the next period to the threshold π. In fact, during an EDP the fiscal policy is fixed at $(g, s) = (\pi, 0)$.

The Commission cares about social welfare which is an integral part of the Commission's utility function. Besides, the Commission faces some political costs when it imposes EDPs. Let the Commission's utility be:

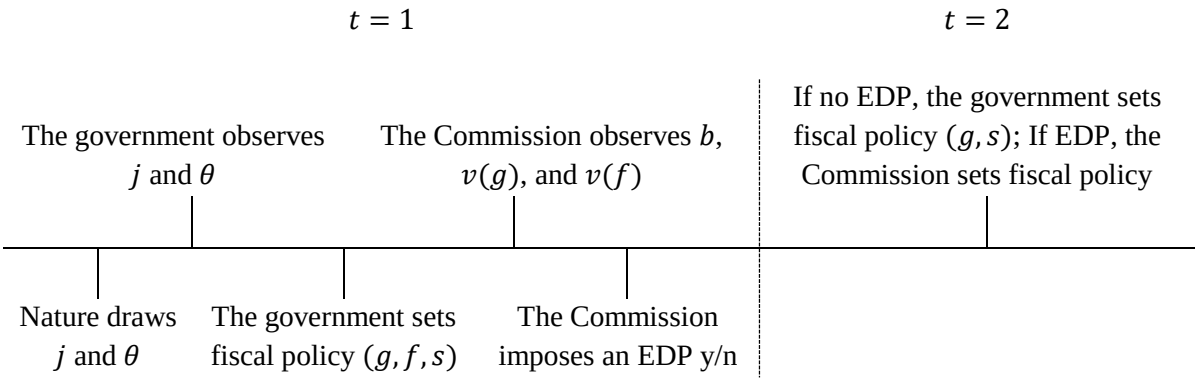
$$W = V - E$$

where we refer to $E > 0$ as 'enforcement costs', which represent all the (political) costs the Commission incurs when it imposes an EDP on disciplined governments. This can be interpreted as the loss in reputation or credibility of being too strict on governments that are actually aiming to maximize social welfare. The Commission can observe the government's total spending b and whether the general public

affairs and the crisis are managed adequately. It also knows the probability distribution of θ and the values of L and H, but it cannot observe whether there is a low or high cost crisis or how the government allocates its budget over the expenditures.

The sequence of events is as follows. First, period one starts and nature draws the government's type j and the costs of solving the crisis θ according their probability densities. Then, the government observes j and θ, and sets its fiscal policy consisting of spending levels for f, g and s. At the end of the first period the Commission observes the total budget and whether public affairs and the crisis are managed adequately, whereas the Commission determines whether to impose an EDP in the next period. Finally, in the second period, either the government can set its fiscal policy consisting of spending levels for g and s, or in case an EDP is imposed, the budget is set by the Commission. Note that there is no crisis in the second period.

Figure 1 Sequence of events



The equilibrium

We are looking for perfect Bayesian equilibria. The strategy profile for governments consist of a fiscal policy (g, f, s) in the first and a fiscal policy (g, s) in the second period. The Commission's strategy profile entails an enforcement strategy that establishes under which conditions it imposes an EDP. More specifically, these conditions include the observed total spending b and whether public affairs and the crisis are managed adequately. The actors' equilibrium strategies must be consistent with their beliefs over the state of the world. We use backward induction to find the equilibria, so we start with the optimal strategies in the second period.

Consider the second period in which in case no EDP is imposed, both types of government are unconstrained from potential sanctions.[15] This means that the disciplined government will set $(g, s) = (\pi, 0)$ which gives the government its maximum second period utility $G - \pi$ which we denote by V_2^*. On the contrary, the undisciplined government will use all the available funds for rent spending represented by fiscal policy $(g, s) = (0, B)$. This gives the undisciplined government a second period utility of B. These fiscal policies mean that the Commission obtains a second period utility of $G - \pi$ denoted by W_2^* when a disciplined government is in office, and $-B$ denoted by W_2^U when the undisciplined government is in office.

In case the Commission imposes an EDP, both types are forced to set $(g, s) = (\pi, 0)$. This gives the disciplined government a utility equal to V_2^* and the undisciplined government a utility equal to zero. The Commission's second period utility becomes W_2^* when there is an undisciplined government in office during the EDP, and $W_2^* - E$ when a disciplined government is in office. The fiscal policies of both government types in the second period imply that the Commission prefers to impose an EDP on undisciplined types, but wants to leave disciplined types unsanctioned. Yet, when it considers an EDP, the Commission looks to the first period.

Suppose for the first period that both government types choose fiscal policies that maximize their utility in that period. Under this strategy, the disciplined government sets $(g, f, s) = (\pi, H, 0)$ with probability q and $(g, f, s) = (\pi, L, 0)$ with probability $1 - q$. The first fiscal policy leads to total spending b_H and the second to b_L, whereas the expected first period utility of the disciplined government then equals $qV_1^H + (1 - q)V_1^L$, where $V_1^H = G - \pi - H$ and $V_1^L = G - \pi - L$. The undisciplined government sets the fiscal policy $(g, f, s) = (0,0, B)$ which yields total spending B and gives him first period utility B. In addition, consider the following Commission strategy:

$$\text{EDP} = \begin{cases} \text{No} & \text{if } b = b_L,\ v(g) = G \text{ and } v(f) = 0 \\ \text{No} & \text{if } b = b_H,\ v(g) = G \text{ and } v(f) = 0 \\ \text{Yes} & \text{Otherwise} \end{cases}$$

This strategy implies that that the Commission does not impose an EDP when it observes a fiscal policy that might be socially optimal, depending on the costs of crisis solving. Given the strategies of both government types and given that the Commission can observe whether the three conditions are fulfilled, this strategy means that an EDP is imposed on the undisciplined type and never on the disciplined type. As a result, the total expected utility under the set of strategies for the Commission is $W = \sigma[qV_1^H + (1 - q)V_1^L] + (1 - \sigma)V_1^U + V_2^*$, for the disciplined government $V = qV_1^H + (1 - q)V_1^L + V_2^*$ and for the undisciplined government's B, where $V_1^U = -B$.

[15] Besley and Smart (2007) suggest that this situation might also occur with an infinite horizon when governments are only allowed to be two subsequent periods in office.

To test whether the situation described above is an equilibrium, we infer whether one of the players has an incentive to deviate from its strategy. Starting with the disciplined government, we conclude that it has no incentive to deviate, since it only cares about social welfare. When the disciplined government is in office and the strategies as described above are played, people's utility will be maximized in both periods.

To consider whether the strategy of the undisciplined government is optimal, note that in the situation described above the disciplined and undisciplined government reveal their types, whereupon the Commission imposes an EDP based on this information. Now consider the situation in which the undisciplined type tries to mimic a disciplined type in order to avoid an EDP in the second period. In this case, the undisciplined government must manage both the public affairs and the crisis adequately and set total spending equal to b_L or b_H. If it chooses $(\pi, H, 0)$ when the costs of solving the crisis are high, and $(\pi, L, 0)$ when the costs of solving the crisis are low, its utility is zero in the first period. If it always sets $(\pi, H, 0)$ its utility is zero if the costs of solving the crisis are high, but its utility can be $\hat{s} = H - L$ if the costs are actually low. Then, the government should set $(\pi, L, \hat{s})$, pretending that the crisis is expensive to solve, after observing low actual costs. Now, it can spend $H - L$ on rent rather than on the crisis. This gives the undisciplined government a first period expected utility of $(1 - q)\hat{s}$.

Let us consider whether this deviation pays off for the undisciplined government under the most beneficial condition that the Commission indeed does not impose an EDP when it observes b_L or b_H while both the public affairs and the crisis are managed adequately. To do so, we look whether the expected utility under the deviation exceeds the expected utility from the revealing strategy which equals B. First, when the undisciplined government observes an expensive crisis and sets pooling fiscal policy $(g, f, s) = (\pi, H, 0)$, its utility equals zero in the first period, whereas it obtains utility B in the second period. Given that it discounts the second period utility, this gives a total utility of δB which is smaller than revealing utility B. We conclude that under an expensive crisis the undisciplined government will not deviate from the revealing strategy. Its discount factor makes it too costly to behave disciplined in the first period and only spend funds on rents in the second period. Second, when the undisciplined government observes low costs of crisis solving, it mimics an expensive crisis and sets $(\pi, L, \hat{s})$. This decision leads to a utility of $\hat{s}$ in the first period, and δB in the second period, and is thus preferred over the revealing strategy when $\hat{s} + \delta B \geq B$, or:

(1) $\quad H - L \geq B(1 - \delta)$

This condition means that when the undisciplined government can pretend much higher costs than the real costs of the crisis, it becomes more beneficial for the undisciplined government to pretend the

occurrence of an expensive crisis. However, the right hand side of condition (1) encompasses the opportunity costs of a pooling fiscal policy. It contains the loss in utility due to discounting from obtaining B in the second rather than in the first period. We conclude that when condition (1) holds it pays off for the undisciplined government to choose a pooling fiscal policy after observing that the crisis can be solved against low costs. When condition (1) does not hold, the revealing fiscal policy will be more beneficial.

Now we consider the Commission's optimal enforcement strategy given that the undisciplined might mimic the disciplined type. First we derive the situations in which the Commission can still infer the government's type with certainty. The Commission knows that the disciplined type will only set b_L or b_H in the first period, and will always manage the public affairs and the crisis adequately. So, when the Commission observes differently, it knows for sure that there is an undisciplined type in office. It updates its beliefs over the government's type according: $\Pr(u|b) = 1$ if $b \neq b_L$ or b_H or if public affairs or the crisis is not managed adequately. In this case, the Commission will impose an EDP. Another situation in which the Commission can infer the government's type is when it observes b_L. Above we saw that for the undisciplined type under a low cost crisis, the revealing fiscal policy $(g, f, s) = (0,0, B)$ dominates the pooling fiscal policy $(g, f, s) = (\pi, L, 0)$. This means that the Commission knows for sure that the government is disciplined when it observes b_L while the public affairs and the crisis are managed adequately during the first period. Thus, after observing b_L, the Commission updates its beliefs over the government's type to $\Pr(d|b_L) = 1$. Given that the Commission's second period utility is higher when it does not impose an EDP on a disciplined type, its best response after observing b_L is to not impose an EDP.

There is one situation left for which we must derive the Commission's beliefs and best response. This is when it observes a budget size equal to b_H while both the public affairs and the crisis are managed adequately. According the best responses, the government in office can be a disciplined type under an expensive crisis with fiscal policy $(g, f, s) = (\pi, H, 0)$ or an undisciplined type under a low cost crisis with fiscal policy $(g, f, s) = (\pi, L, \hat{s})$. This means that the Commission cannot infer with certainty whether the government is disciplined or undisciplined. When the Commission observes this situation, it must choose whether to impose an EDP based on its expected utility and its beliefs over the government's type. It will not impose an EDP, when its corresponding expected second period utility exceeds the expected utility of an EDP. That is, if $\Pr(u|b_H)\, V_2^U + \Pr(d|b_H)\, V_2^* > \Pr(u|b_H)\, V_2^* + \Pr(d|b_H)\, (V_2^* - E)$. When we insert $V_2^* = G - \pi$ and $V_2^U = -B$, we can rearrange this condition into:

$$(2) \qquad \Pr(d|b_H)\, E > \Pr(u|b_H)\, (G - \pi + B)$$

where $\Pr(u|b_H) = 1 - \Pr(d|b_H)$. The intuition behind this condition is simple. The left hand side represents the Commission's utility loss when it imposes an EDP on a disciplined government, whereas the right hand side is the utility difference between an undisciplined government with and without EDP.

Since the Commission knows the probability distributions of the crisis solving costs and the government's type, it can use Bayes' rule to update its beliefs over the government's type in office. When we let $\lambda = 1$ represent the case in which condition (1) holds and $\lambda = 0$ the case in which condition (1) does not hold, Bayes' rule implies that:

$$(3) \qquad \Pr(d|b_H) = \frac{q\sigma}{q\sigma + \lambda(1-q)(1-\sigma)}$$

So, the Commission's belief stemming from (3) is not only based on the prior probabilities of crisis solving costs and government type. The Commission also considers whether the undisciplined government would be willing to mimic the disciplined government.

When it pays off for the undisciplined government to pool, such that λ equals one, the Commission updates its beliefs to $\Pr(d|b_H) < 1$ and is thus uncertain about which government type it faces after observing b_H. This means that the Commission after observing b_H takes into account that the government might be undisciplined. This changes condition (2) in favor of imposing an EDP. Hence, the left hand side is increasing in $\Pr(d|b_H)$. If condition (2) holds, despite the Commission's suspicion that there might be an undisciplined government in office, the Commission will not impose an EDP.

When λ equals zero, such that pooling does not pay off for the undisciplined government, $\Pr(d|b_H)$ will be equal to one which means that the Commission knows with certainty that there is a disciplined government in office after observing b_H. In this case, the entire right hand side of the Commission's EDP condition (2) will become zero and the Commission will never impose an EDP when it observes b_H, given that its enforcement costs E are positive. In other words, when the Commission observes a total budget of b_H while it knows that a pooling fiscal policy does not pay off for the undisciplined type, it knows for sure that there is a disciplined type in office. This ensures that the Commission will not impose an EDP after observing b_H and adequately managed public affairs and crisis.

Besides that the Commission takes the incentives of the undisciplined government into account, the undisciplined government also considers the Commission's enforcement response. When condition (1) holds, but the Commission's EDP condition (2) does not hold, the government will not pool, since it knows that it gets sanctioned. This makes condition (1) a necessary but not a sufficient condition. For the existence of a pooling equilibrium, also condition (2) must hold.

Thus, whether there exists a pooling equilibrium depends on two conditions. When an undisciplined government observes a low cost crisis, it will only set the pooling fiscal policy $(\pi, L, \hat{s})$ if both conditions (1) and (2) hold. Otherwise, it will set the revealing fiscal policy $(0, 0, B)$. When the Commission observes budget size b_H while the public affairs and the crisis are managed adequately, it will still impose an EDP if condition (1) holds and (2) does not hold. However, this latter is an out-of-equilibrium decision since the undisciplined government will not pool when (2) does not hold as we have shown above. Formally, this leads to the following equilibrium:

Lemma 1 *(The pooling equilibrium)*

There is a pooling equilibrium in which the undisciplined government that faces a low-cost crisis mimics a disciplined government under a high-cost crisis when this pays off for the undisciplined government (condition 1 holds), and it is too costly for the Commission to impose an EDP (condition 2 holds). This equilibrium encompasses the follow actions. The undisciplined government sets $(g, f, s) = (\pi, L, \hat{s})$ in the first period, and $(g, s) = (0, B)$ in the second. The disciplined government sets $(g, f, s) = (\pi, L, 0)$ in the first period, and $(g, s) = (\pi, 0)$ in the second period. The Commission does not impose sanctions when it observes that the public affairs and the crisis are managed in the first period, and the total budget equals b_L (i.e. $\pi + L$) or b_H (i.e. $\pi + H$).

Lemma 2 *(The revealing equilibrium)*

There is a revealing equilibrium in which the undisciplined government does not manage public affairs and the crisis in the first period, after which the Commission (certain of the government's type) will impose an EDP. This occurs when it does not pay off for the undisciplined government to mimic the disciplined type, or when the Commission will impose an EDP when the pooling fiscal policy is set. This revealing equilibrium contains the follow actions. The undisciplined government sets $(g, f, s) = (0,0, B)$ in the first period, whereas in the second period it is subject to an EDP. The disciplined government's first period fiscal policy is $(g, f, s) = (\pi, L, 0)$ when there is a low-cost crisis, and $(g, f, s) = (\pi, H, 0)$ when there is a high-cost crisis, whereas it sets $(g, s) = (\pi, 0)$ in the second period if the Commission did not impose an EDP. The Commission does not impose an EDP if the public affairs and crisis are managed adequately in the first period and the budget equals b_L (i.e. $\pi + L$). In addition, it does not impose an EDP if the public affairs and crisis are managed in the first period, the budget equals b_H (i.e. $\pi + H$), and condition (1) does not hold.

These equilibria lead to the following equilibrium utilities. First, the disciplined government has two equilibrium utilities. Under a low-cost crisis its utility will be $2(G - \pi) - L$, and under a high-cost crisis $2(G - \pi) - H$, where the former is always higher than the latter. The disciplined government's utility

is unaffected by the Commission's decision whether to impose an EDP, since an EDP leads to the same fiscal policy in the second period as the disciplined government would have set.

Also the undisciplined government has two equilibrium utilities. Under a pooling equilibrium the undisciplined government obtains $H - L + \delta B$, and under a revealing equilibrium B. In the pooling equilibrium, the pooling utility is higher than the revealing utility, otherwise the government could simply have chosen to set the revealing fiscal policy.

The Commission has five different equilibrium utilities. Three elements determine which one is obtained: *i*) the costs of crisis solving, *ii*) the government's type, and *iii*) whether there is a pooling or revealing equilibrium. First, the highest utility is obtained when there is a low-cost crisis and a disciplined government. Then, the Commission's utility will be $2(G - \pi) - L$. The second highest utility is when there is a disciplined government under a high-cost crisis and a revealing equilibrium. Then, the Commission's utility will be $2(G - \pi) - H$. The ranking of the other equilibrium utilities depends on the height of the enforcement costs. When there is a disciplined government under a high-cost crisis and a pooling equilibrium, the Commission's utility will be $2(G - \pi) - H - E$. When there is an undisciplined government under a low-cost crisis and a pooling equilibrium, the Commission's utility will be $G - \pi - H - B$. Finally, when there is an undisciplined government and a revealing equilibrium – no matter what the crisis solving costs are – the Commission's utility will be $G - \pi - F - B$. Further insights and interpretation of these equilibrium utilities are provided below.

Before we list our four main findings, we depict the insights derived from conditions (1) and (2). We start with condition (1), which determines whether the undisciplined government is willing to pool: $H - L \geq B(1 - \delta)$. When this condition holds, it is beneficial for the government to constrain its rent spending in the first period, avoid an EDP, and extract maximum rent in the second period. We draft two conclusions from this condition. First, when the difference between L and H becomes larger, pooling is more likely. That is, when the government is able to pretend that the crisis solving costs are much higher than the actual costs, it becomes more beneficial to overstate the crisis' fiscal impact (i.e. to pool). Second, when the government is less patient (i.e. a lower δ), it is more likely that it will grab all the rents in the first period (i.e. reveal).

Then, condition (2) determines whether the Commission will impose an EDP when it cannot infer the government's type with certainty: $\Pr(d|b_H)\, E > \Pr(u|b_H)\, (G - \pi + B)$. When this condition holds, the Commission will be lenient and omit an EDP. This is the case when the enforcement costs (E) are higher, or when it stronger beliefs that there is a disciplined government in office.

Findings, interpretations, and propositions

Based on the equilibrium strategies, equilibrium utilities, and the conditions for the equilibria, we derive four main findings. Note that these findings are to some extent interrelated.

First, we find some implications for social welfare. Suppose there is a low-cost crisis. Then, social welfare is the highest when there is a disciplined government in office. However, when there is an undisciplined government in office, the social welfare depends on whether there is a pooling or revealing equilibrium. A pooling equilibrium yields a social welfare of $G - \pi - H - B$, whereas social welfare is $G - \pi - B - F$ under a revealing equilibrium. This means that a pooling equilibrium is always better for social welfare, since $H < F$, which holds by assumption[16].

The reasoning behind this finding is as follows. Under both equilibria, there is always one period in which everything is managed adequately by the undisciplined government. This is the first period under the pooling equilibrium, and the second period under the revealing equilibrium. However, the first period contains public affairs and a crisis, whereas the second period only contains public affairs. As a result, opportunistic behavior during the first period is more costly, than in the second period, since then there is more 'at stake'. Consequently, a well-behaving government in the first period (the pooling equilibrium) is preferred over a well-behaving government in the second period (the revealing equilibrium).

Second, our first finding has an interesting implication for the fiscal pact's enforcement. Given that a pooling equilibrium is better for social welfare than the revealing equilibrium, we find that some enforcement costs are welfare enhancing. Consider condition (2): $\Pr(d|b_H)\, E > \Pr(u|b_H)(G - \pi + B)$ which captures whether the Commission imposes an EDP after not being able to distinguish the government's type. Accordingly, when (2) holds, the Commission will not impose an EDP in this situation, and the undisciplined government might set the pooling fiscal policy. Thus to obtain a pooling equilibrium $\Pr(d|b_H)\, E$ must exceed $\Pr(u|b_H)(G - \pi + B)$. This means that the enforcement costs (E) must be sufficiently high to allow for the pooling equilibrium.

To understand this finding, suppose that the Commission does not face any enforcement costs ($E = 0$). Then, after observing a fiscal policy that might belong to an undisciplined government, it always imposes an EDP. Hence, with $E = 0$, condition (2) will never hold – there is no 'brake' on strict enforcement. The undisciplined government takes this Commission's best response into account when

[16] Hence, when the disutility of an unsolved crisis (F) would be smaller than the highest crisis solving costs (H), social welfare would be maximized by not solving the crisis to save the budget. We ruled out this possibility with our assumption that $H < F$.

it considers its first period fiscal policy, and will never set a pooling fiscal policy. It is simply scared off by the Commission's aggressive enforcement and will always set the revealing fiscal policy, which is suboptimal for social welfare. Although one might argue that this is not the Commission's best response (since it leads guaranteed to the suboptimal revealing equilibrium), the Commission cannot commit to be lenient when $E = 0$.

The interpretation of this finding is as follows. When European Commissioners do not care about their reputations and are insensitive for any public pressure to apply the fiscal rules in a flexible manner ($E = 0$), governments are doomed as lame ducks. Knowing that the enforcer of the fiscal rule is a pure technocrat who will impose EDPs anyway, governments will grab maximum rents before the enforcer is able to react. This happens under the revealing fiscal policy, which is the equilibrium when enforcement costs are too low. As a result, insufficient funds will be spend on crises and public affairs. We thus conclude that enforcement costs are welfare enhancing since they make that the enforcer can credibly commit to flexible enforcement which 'invites' governments to pursue disciplined fiscal policies. In other words, we find that strict enforcement discourages government's crisis solving. When we combine our first two findings we can state that:

Proposition 1 *Some enforcement costs enhance social welfare. Without enforcement costs the Commission cannot commit ex-ante to flexible enforcement in case of crises or other contingencies. Knowing that the Commission might enforce the fiscal rules strictly, governments would not earmark part their budgets to invest in crisis solving measures.*

Third, based on the findings above, we conclude that undisciplined governments benefit from high enforcement costs. When it is beneficial for the undisciplined government to pool (condition (1) holds), but the enforcement costs are too low (condition (2) fails), it cannot obtain the higher pooling utility. Although we modelled the Commission's enforcement costs as exogenous, this finding suggests that governments have an incentive to increase the Commission's enforcement costs. In reality, they might do this by raising public awareness for the fiscal pact's disciplining pressure in the presence of the crisis' fiscal needs. Moreover, they might emphasize high crisis solving costs (see the fourth finding). We capture this finding in the following proposition.

Proposition 2 *Governments have an incentive to increase the enforcement costs of the Commission. Enforcement costs make the Commission's enforcement more lenient which is beneficial for the governments.*

Fourth, we find that governments can exploit their informational advantage over the fiscal implications of crises and their budget allocation. Consider what happens in the pooling equilibrium. The

undisciplined government observes a low-cost crisis, but in order to obtain a higher utility, it pretends that there is a high-cost crisis. When the Commission could observe the actual costs, the government could not do this. Moreover, if the Commission could observe the precise budget allocation, the government could not extract any rent without revealing its type. Thus, the information asymmetry provides the government with an opportunity to spend public funds on rent, and increase its utility.

Proposition 3 *To avoid enforcement of the SGP, governments can use their informational advantage over the fiscal impact of crises (or other contingencies) and over their budget allocation. Moreover, pretending that crises have a large fiscal impact can hide other public expenditures.*

5. Recent cases

In the absence of an empirical assessment of our model, we provide some examples to support our theoretical findings. All examples are recent applications of the SGP in which the Commission's enforcement played a major role.

Our first example is related to our argument that governments have an incentive to emphasize the fiscal impact of crises to trigger enforcement costs. Europe encountered a migrant crisis in 2015 which required public spending to facilitate the migrant flow and to shelter and integrate the refugees. In the fall of 2015, some people started to argue that the Commission should exempt these expenditures from the SGP. Among them was the Austrian Minister of Finance Hans Joerg Schelling[17]. To backup this argument, some EU member state governments used their Draft Budgetary Plans (DBPs) – submitted in October of the year – to emphasize their difficulties to cope with the additional fiscal needs under the disciplining force of the budgetary restrictions. In particular, Austria, Italy, Belgium, Germany, and Finland addressed the expenditures related to the migrant crisis in their DBPs. The Belgian government even referred to the specific SGP provision that "an unusual event outside the control of the Member State concerned"[18] can be exempted from the rules. The Belgian budget was at odds with the rules under the SGP, and the exemption was clearly in the Belgian's interest. After all, on the 17th of November 2015, the Commission's Vice-President Valdis Dombrovskis said that the Commission will apply the 'unusual event' provision to the migrant crisis, which meant the exemption of all the migrant related expenditures[19].

[17] Reuters, 5 October 2015, "EU states might get budget relief on refugee costs – officials"
[18] Council Regulation 1466/97 Art. 5
[19] European Commission, speech/15/6102, 17 November 2015, "Press remarks by Vice-President Dombrovskis on the Commission's Opinions on draft budgetary plans"

The second example shows how governments use the Commission's enforcement costs in their advantage. It concerns the terrorist attacks in Paris in November 2015, and the corresponding call for enhanced national security measures. On the 13th of November, 130 people were killed in the 'Paris shootings'. This and other recent terrorist attacks in Europe raised pressure on governments to increase public spending on national security and counterterrorism. On the 16th of November – three days after the attacks – the French President François Hollande and Prime Minister Manuel Valls argued that the Commission should provide budgetary leeway to France to allow for these additional security measures[20]. The same day, Pierre Moscovici, the European Commissioner responsible for the SGP's enforcement, responded and declared that he will take into account "the tragic situation faced by the country" for France's SGP compliance and "will evaluate the impact [of the terrorist attack] in due course"[21]. In other words, the Commission declared that is willing to allow for the exemption. Since this announcement came three days after the Paris shooting, we argue that there are enforcement costs at stake. We argue that so short after a terrorist attack that killed so many people, the Commission could not refuse the French call for an exemption. While the human losses were still fresh in people's mind, strict SGP enforcement was politically undone. The French government used the Commission's high enforcement costs in their advantage.

Our third example concerns the informational advantage of governments over their budget allocation and the fiscal impact of crises. As we have seen above, the Commission took a flexible enforcement stance towards counterterrorism expenditures. Not only France stepped up national security in the wake of terrorism, also Italy incurred additional security related costs. However, the Italian government got in a dispute with the Commission about the destination of these funds. In short, the Italian government passed a 'Stability Law' which encompassed security measures worth 0.2% of GDP. Italy presented this Stability Law to the Commission in its Stability Programme submitted in April 2016. In its assessment of this Stability Programme, the Commission declared however to be critical and not willing to provide Italy the budgetary exemption. The Commission found the link between some of the presented measures and national security weak: "as in the case of EUR 1 bn earmarked for the requalification of urban areas and incentives to young people to attend cultural events. A preliminary assessment thus suggest that only 0.06% of GDP represents additional directly security-related expenditure […]"[22]. So, according the Commission's assessment, Italy tried to 'sell' expenditures up to 0.2% of GDP as national security measures, whereas only 0.06% would qualify. Our model's pooling equilibrium touches upon this example. The Italian government used the national security measures as label to hide other expenditures. In this case, however, the Commission was able to detect this opportunistic behavior, and to enforce the SGP accordingly.

[20] Financial Times, 17 November 2015, "France slams European Commission on budget deficit warning"
[21] The Wall Street Journal, 17 November 2015, "EU Warns Four Countries on 2016 Budget Plans"
[22] European Commission, 26 May 2016, "Assessment of the 2016 Stability Programme for Italy", p.21

Finally, a similar dispute evolved regarding the Italian public expenditures to rebuild infrastructure after deadly earthquakes in 2016's fall. Soon after the earthquakes, it became apparent that the Italian government receives budgetary leeway in the context of the SGP[23], whereas their migrant related costs were exempted already. However, the Italian Prime Minister Matteo Renzi and Commission President Jean-Claude Juncker ended up in an argument about the fiscal impact of both 'unusual events'. According to Renzi, the impact on Italy's 2017 budget comprehends 0.4% of GDP, whereas Juncker argued that this was only 0.1%[24]. Although governments have more information over their budgets and domestic affairs than the Commission, this latter knows that the governments also have an incentive to lie about it. It is in line with our findings if Renzi would overstate the fiscal impact, as well as Juncker's suspicion about the figures Renzi provided.

6. Discussion

This paper builds on the literature on government spending under the disciplining force of fiscal rules. In contrast to earlier models, this paper focuses on the incentives of the fiscal rules' enforcer, given that the enforcement is delegated to a political actor who cares about more than public finances only. Focusing on the European context, it addresses the question what the incentives of the Commission are in the enforcement of the SGP, and how individual governments take these incentives into account. Based on literature and actual cases, it distinguishes various rationales that make the Commission lenient in its enforcement and presents a game-theoretical model to map the corresponding interaction with individual governments. Finally, examples are provided to support the theoretical findings.

We find two groups of political rationales that make the Commission lenient. First, cases have shown that the Commission takes public opinion into account when it enforces the SGP. This makes the Commission lenient after 'unusual events' and during Eurosceptic times. It does so, not only to prevent reputational losses of Commissioners as politicians, the Commission as organization, or the EU as governmental layer, it also needs public support to make governments comply with the fiscal rules. Second, the Commission aligns SGP enforcement with its political agenda. It uses exemptions to incentivize particular expenditures and to affect governments' fiscal policies. We conclude that these rationales enhances enforcement costs for the Commission.

Accordingly, our model simulates the SGP's enforcement given that the Commission has these incentives to be lenient. Based on our model we found that some enforcement costs are welfare enhancing. When the Commission would enforce the SGP in a strict fashion, governments would be

[23] Politico, 27 October 2016, "Pierre Moscovici, trying to make Italian duvet fit EU suitcase"
[24] Reuters, 8 November 2016, "Stop attacking EU Commission on fiscal policy, Juncker tells Renzi"

careful in earmarking funds for welfare-enhancing measures. Second, our model showed that governments have an incentive to increase the Commission's enforcement costs. Governments may publically emphasize the SGP's downward pressure on budgets while additional public expenditures are needed to accommodate crises or other contingencies. Being a political actor, the Commission is sensitive for this public pressure to enforce the SGP flexible. Third, based on our model we conclude that governments can exploit their informational advantage over domestic affairs and their budget allocation. Governments can mimic a large fiscal impact of crises, to undermine enforcement, and to hide other expenditures. We provide examples to support our theoretical findings.

Thus, our paper provides an explanation for the several breaches of the SGP in the absence of sanctions. It shows why the Commission is sometimes reluctant to step-up sanctions, and why governments emphasize contingencies like natural disasters and other crises.

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